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The title of this essay is, of course, "borrowed" from that of Nikolai Bukharin's work of the same name, *Ekonomika perekhodnogo perioda,* which appeared in 1920 at the height of War Communism and referred to transition in a quite different direction. Here we will be discussing the problems of moving from an economy based on directive planning (in which many directives were ambiguous, irrational, or distorted in execution) to one based on market. There will be a mix here of theory and practice. It will not be possible to go into detail. Many countries are involved, at different levels of political culture and economic development, different also in the degree of imbalance "achieved" in the last years of Communist rule and in the extent to which market-type reforms and legal private activities already existed.

To take a few examples: Poland's agriculture was predominantly private, some private enterprise was allowed (albeit subject to limits), but at the same time there was an economic crisis with strong inflationary pressures, so that the freeing of prices in 1989-90 was accompanied by a hyper-inflationary surge. By contrast, Czechoslovakia inherited from the Communists a comparatively balanced economy with few shortages, but one in which virtually all private or even cooperative enterprise had long been outlawed. Hungary had introduced a New Economic Mechanism already in 1968, explicitly committed to marketization, and though under increasing strain, the Hungarian economy in 1989 was not suffering from the degree of macroeconomic imbalance which afflicted Poland. "Shock therapy" was therefore avoidable. Russia at the time of the coup that eliminated the Communist Party was in a state of acute crisis, characterized by physical shortages, the collapse of the currency, a totally distorted price system and a soaring budget deficit, while further strains were imposed by the breakup of the Union and Comecon. Each of the former Soviet republics presents problems of its own, and some of them (Armenia, Azerbaijan, Moldova) are seemingly more concerned with military action than with reform. This, most tragically, also applies to the republics that once made up Yugoslavia. Even in Czechoslovakia there is the issue of Slovak secession, and tension between Russia and Ukraine (for example, over the Crimea) causes foreboding and obstructs economically rational cooperation.

Transition to what? At first the reformers were seeking some "third way," some form of market socialism, that is, a mixed economy with some private enterprise but with public (state, municipal, cooperative) ownership of the majority of the means of production. I developed this model in my *Economics of Feasible Socialism,* which at the time it was written, 1980-82, seemed to be a radical reform program. But now the pendulum has swung very much further. The direction of transition is now seen to be to some form of capitalism. There is not and cannot be a third way, argued Janos Kornai and

the large majority of those in charge of the reform process in virtually all these countries. The pendulum has swung so far that even Erhard's *Soziale Marktwirtschaft* is regarded with suspicion because of the sinful word *Soziale,* and articles attack the welfare state (in its West European form) as excessively "socialist." Friedrich August Hayek and Milton Friedman are extolled, advisers from right-wing or neo-conservative think tanks are welcomed.

While I am personally alarmed and unhappy about this apparent triumph of laissez-faire ideology, this is not the place to enter into dispute about the existence or nonexistence of alternatives to capitalism. Let us assume that the objective of the reformers is some sort of "capitalism with a human face." How does one get there? What help can be sought from economic theory? Or from the practice of other countries seeking to recover from war? The latter experience is useful for two reasons. First, in most warring countries the state played a large role as economic "controller," and the steps by which the controls were dismantled may be of direct interest to our colleagues in the "East." The role of foreign help in their recovery is also relevant today, for example, the Marshall Plan. Second, Russia, Poland, Romania, and most of the republics of the former Soviet Union face a degree of disruption analogous to what is suffered in wartime; thus, the break with former suppliers and customers could be seen as a rough equivalent of wartime supply hazards caused by submarines or bombing. Some argue that the parallel with the postwar experience of Western Europe does not hold, is irrelevant, because these countries had long-established market structures to which it was relatively easy to return. However, while true, this merely underlines the difficulty faced by countries such as Russia, where the grave economic situation (as bad as that faced by many countries in 1945) is combined with the *absence* of established market structures, which still have to be created.

NEO-CLASSICAL THEORY AND THE REAL WORLD

I have developed at length elsewhere a critique of neo-classical theory as applied to the real world.[1] In this connection I would like to quote Raymond Dietz's essay on "Reform of Soviet Socialism": "It may be that reforms in the east have come about not because of but despite theory. The reality of reform in East Europe and in the USSR displays a dynamic that leaves mainstream economics more or less speechless...."[2]

Also of great importance and of varying degrees in different countries is what could be called *market culture,* and those institutions and legal structures without which a market economy cannot effectively function. Clearly these were more developed in, say, Hungary than in Russia, more in Estonia than in Azerbaijan. Stimuli, such as higher prices or interest rates, can have quite different or even perverse effects in different environments.

MACROECONOMIC STABILIZATION

Let us begin with the task of macroeconomic stabilization. In Poland, Romania and Russia the task has been particularly difficult, owing to the consequences of past policies. The large budget deficits had been financed by money creation. There was no way they could be financed by the sale of bonds, as the United States deficit has been, since there would be far too few buyers. In the last years of the Soviet Union, problems were compounded by the gradual collapse of political authority, and by the emergence of increasingly independent republics, which spent freely and further undermined the already weak ruble. By 1991 the combined budget deficits reached 20 percent of gross national product (GNP). The formerly centralized banking system was in disarray too, weakening control over the volume of credit. Wage payments, formerly regulated strictly by the "wages fund" limits imposed on enterprises and institutions, also rose sharply, since there was no hard budget constraint to replace these imposed limits. Attempts to hold down prices led to ever higher subsidies, and so to higher budget deficits, while shops emptied and the collapse of the material allocation system was being replaced not by the market but by a clumsy and incomplete network of barter deals.

1 See, for example, my *Studies in Economics and Russia* (London: Macmillan, 1991).
2 *Reform and Transformation in Eastern Europe,* edited by J. M. Kovacs and M. Tardos (London: Routledge, 1982), p. 22.

Clearly, no move towards a market economy could succeed without the creation of real money in the place of the rapidly depreciating currency. It was therefore entirely right to give high priority to macroeconomic stabilization, cutting the budget deficit, drastically reducing subsidies, imposing financial discipline, and stopping the printing of too much money. This task could not be separated from *price reform*, both because the subsidy bill was a major cause of budget imbalance, and because prices which reflect neither relative scarcities nor use values are useless, indeed an obstacle, in the context of marketization. This, in turn, raised questions of destatization, privatization, monopoly, incomes policy, liberalization of foreign trade, and convertibility of currency. Of great importance too are such matters as finding the correct *sequence* of measures, and the degree of shock and sacrifice that the population can or should endure. In this connection, it may be worth citing—of all people—Hayek. It is precisely in his well-known *Road to Serfdom*, written in 1944, that he stated: "This is perhaps the place to emphasize that, however much one may wish for a speedy return to a free economy, this cannot mean the removal at one stroke of most of the wartime restrictions. Nothing would discredit the system of free enterprise more than the acute, though probably short-lived, dislocation and instability such an attempt would produce." Interestingly, this was cited by B. Milanovic of the World Bank, and contrasted with the view of Jeffrey Sachs, in an article on Poland.[3]

One should be aware here of a dilemma. A vital cause of the failure of Gorbachev's attempts at reform was precisely a fear of the political and social consequences of a long-overdue increase in prices and the cutting of subsidies to food and housing. Also, where the gap between supply and demand is as great as it became in Russia and Poland, a gradual increase in prices is no solution. Thus, if meat was officially priced at 2 rubles and the free-market price were 10 rubles, there is little point in fixing a new price at 4 rubles (while continuing to print money to cover a large budget deficit). And one of the weaknesses of the plan presented to Gorbachev in 1990, bearing the names of Shatalin and Yavlinsky, was that they wished to postpone price increases until macrostabilization had been achieved. This was an impracticable sequence, given the burden of subsidies on the budget. But more about prices later.

In order to balance the budget it is necessary to cut other expenditures too. Defense spending, particularly high in Russia, was an obvious candidate, and as a matter of historical fact major cuts were resisted far too long by the military-industrial complex. (This should not surprise us, given the reluctance of the United States to make any serious cuts in its huge defense budget even after the disappearance of the Enemy.) However, the conversion of defense plants to civilian production calls for considerable investment expenditures. Furthermore, while in the former Soviet Union there were many instances of wasteful investments, as well as a chronic imbalance between the demand for investment goods and the supply of these goods, leading to long delays in construction, there was no obvious short-term alternative to continuing *state*-financed investments. This was and is a problem in all ex-Communist countries: privately owned capital is scarce or in the possession of corrupted former officials or shady dealers ("the Mafia"), and, given the uncertainties—affecting politics, inflationary expectations, and in Russia the lack of a well-defined legal order—private capital was unlikely to be invested in long-term projects. During the first postwar years in Britain there was no shortage of private capital seeking investment outlets; on the contrary, it was thought necessary to impose a form of capital rationing on the private sector in order to concentrate investments on what were judged to be priority sectors. There will be more to say about the requirements of capital restructuring. For the moment it may be sufficient to note that the Russian statistical report for the first quarter of 1992 noted a decline by 44 percent in the volume of investment, which "threatens dire consequences in the immediate future... In this situation, the correct choice of priorities in investment policy is vital."[4] But, as we shall see, ideological commitment to laissez-faire stands in the way of devising, let alone implementing, an investment policy.

Other cuts in expenditures affect social services (pensions, health, education), as well as science, the arts, public transportation, and other infrastructure. An obvious difficulty is the inescapable increase in unemployment, and consequently,

3 *Soviet Studies*, no. 3 (1992), p. 511.
4 *Ekonomika i zhizn'*, no. 17 (1992).

unemployment pay. More of these matters, too, below.

Revenues can be increased through higher taxation of firms and individuals, the introduction of value-added tax, and excise duties to replace turnover tax. However, the effect of price increases on the real incomes of the population, the decline in production associated with shock therapy, and also the need to provide incentives for entrepreneurship, stand in the way of balancing the budget by raising taxes.

Efforts to reduce the deficit must be made, but no painless methods exist by which this can be achieved.

INTER-ENTERPRISE DEBT

Credit control presents grave problems, too. These have two distinct aspects. One is the effect of the creation of a large number of commercial banks and other credit-granting institutions, which, especially in a climate of deregulation and the weakening of central authority, could not be effectively controlled in Russia. The other is a consequence of hyperinflation: a large number of enterprises in both Russia and Poland found themselves in grave financial difficulties because of a sudden and very large increase in the prices of labor and materials: thus, in Russia wholesale prices in March 1992 exceeded those of March 1991 thirteen (13) times! Farms had been paid at 1991 prices, but faced similar, or even larger, increases in the costs of material inputs in 1992. Publishers had sold subscriptions in 1991 for the coming year, but in January 1992 the price of paper increased nearly twentyfold. Firms in financial difficulties delayed payments to suppliers, and they delayed payments to *their* suppliers. Inter-enterprise debt rose exponentially, as the following figures show:

Russia: Debts Unpaid (Billions of Rubles)	
1 January 1992	39.2
1 February	140.5
1 March	390
20 March	676
End of May	2000

(Sources: *Izvestiya*, March 28, 1992; *Nezavisimaya gazeta*, June 17, 1992.)

Clearly, under these circumstances a denial of credit and insistence on bankruptcy proceedings would eliminate at a blow a high proportion of producers, and equally clearly, their financial difficulties could not be ascribed to inefficiency—though no doubt some enterprises were inefficient or produced goods which were not in demand. This helps to explain why, so far, bankruptcies have been few, and why the budget deficit and banking have not been brought under the degree of control called for the by the adopted strategy (and by the IMF). A rigid enforcement of the strategy would bring about the total collapse of production and multimillion unemployment.

In other countries, too, inter-enterprise debt has grown. For example, in Czechoslovakia from 7.1 billion crown at the beginning of 1990 to 53.9 million at the end of that year.[5] However, the imbalances of the Czechoslovak economy were far less and it was possible to impose a restrictive credit policy without disaster. The same has been true of Hungary. But these experiences underline the difficulty of applying the logic of monetarism to the real world. Policy could not be as restrictive as required by monetarist doctrine.

PRICE POLICY

As mentioned above, price policy must be seen as an integral part of the reform and stabilization process. And in countries such as Russia, Poland, Romania, and Bulgaria it had to involve a very large rise in both wholesale and retail prices, because of the large monetary overhang and the consequences of past errors of policy. Since experience shows that it is impossible to control flexibly several million prices, an essential feature of reform must be the release from any control of the large majority of prices. Some would say—*all* prices, but as we shall see, this can be impracticable in the transition period, even if all accept the ultimate aim to abandon such controls. One question frequently raised is that of monopoly. In Russia and many other ex-Communist states competition is absent not only or mainly because of state ownership; it is possible to envisage state-owned enterprises competing, and some have done so—for instance, theaters and literary journals. The problem, apart from such "natu-

5 J. Charap, et al., *Communist Economies*, no. 1 (1992), p. 5.

ral monopolies" as water, gas, and electricity, is that there is frequently only one producer of some specific item, for example, an agricultural machine, typewriters, or newsprint. Even in Russia this can be the case, and it is more likely to be so in the smaller countries. Or the several producers have been grouped into one corporation. In the latter case it may be possible to create competition by forcibly breaking up the corporation, but plainly this is not always either practicable or desirable: would we wish to order the breakup of DuPont or Imperial Chemical Industries? In the smaller countries, economies of scale militate against artificially creating competing firms. Competition, of course, can come from imports, but this may not be practicable in the short run, given the balance of payments constraint. (We shall be returning to the problem of the role of foreign trade and convertibility later.) Total price decontrol provides an opportunity for enterprises to use monopoly power greatly to raise both profit and wages, while not increasing output. Yet total control is unworkable and undesirable. Selective control of prices on some key items—materials, energy, some basic foods—may prove essential in the transition period, despite problems of enforcement and the emergence of black markets. One device, used for clothing in Great Britain in the war and first postwar years, is to exempt the price-controlled items from purchase tax (the "utility" scheme).

Great Britain was among the last countries to abandon food rationing after the war. This is not necessarily a good example to follow, for two reasons. First, it does seem that by 1949 there were no objective reasons for continuing with rationing, other than the ideological notion—which the Labour Party had imbibed in the war years—that "rationing by coupons" is somehow more just than "rationing by the purse." The other was the exceptionally large role of imports in the British food balance in those years, which enabled the government to maintain strict control over the allocation of, for example, meat and butter, and kept the black market to a minimum. Whereas, for example, in France, with its big peasant farming sector, rationing was far more difficult to enforce, black markets flourished, and rationing was abandoned earlier than in Britain. In Russia a legal free market existed for fifty years alongside the state stores and with prices often much higher. The coexistence of several very disparate prices provides opportunities for large profits through diversion, arbitrage, bribery, and, with the decline in the power of the state and Party under Gorbachev, these opportunities could be increasingly taken. The gap between prices of various categories grew to truly astronomic proportions. Two examples can be cited. The first relates to December 1991, when this author encountered the following prices for a three-course lunch: 6.50 rubles in an "academic" hotel, 300 rubles in a "commercial" restaurant, 1200 rubles (if $12 were converted at the free exchange rate of that date) in a *valyuta* (hard currency) restaurant. The second relates to the price of oil in April 1992, when prices were still subject to control. The official price per ton was 350 rubles. But there were also commodity exchanges, where the price was 2000-2500 rubles without an export license, 5000-6000 with a license to sell to other ex-Soviet republics, 8000-10,000 with a license to sell "beyond the further Soviet borders." The opportunities for enrichment via corruption were all too obvious. This represents a powerful argument for a single, free price, which would eliminate or at least substantially reduce such opportunities. It may also be argued that prices should be aligned to world prices, especially for items entering foreign trade.

THE GAP BETWEEN DOMESTIC AND WORLD PRICES

However, where the gap between domestic and world prices is very large, there is usually a similar gap between incomes (converted at the free exchange rate). To take a Russian example, the average wage in April 1992 was the equivalent, at this exchange rate, of at most $15 per *month.* If prices of oil and other sources of energy were set at world levels, the consequences would be devastating in terms of individual purchasing power and industrial, agricultural and transport costs. But if they were not, given the right to acquire and dispose of foreign currency, it would clearly pay the producers and traders to sell abroad oil and any other exportable item. To prevent this it has been necessary to impose either export licensing, or an export tax, or both.

Is it politically feasible to raise prices of necessities at a blow to levels that balance supply and demand? Gorbachev and his advisers felt that this was too risky, and postponed decision for far too long, so that when the increase was decided, prices rose sixfold and more. Gavriil Popov, editor of *Voprosy ekonomiki* (Problems of Economics) and, subsequently, mayor of Moscow, had proposed in 1989

a transition period in which a short list of foodstuffs was rationed, while all other prices (including those foodstuffs off the ration) were freed, thus minimizing hardships for the pensioners and low-paid. This proved unacceptable, and quite probably would by then have been impracticable, as the center no longer had sufficient control. But the idea had much to commend it as a way of avoiding social convulsions, and at least promised better than what actually was done in Russia in 1989-90, which was—nothing.

THE FALL IN PRODUCTION AND LIVING STANDARDS

Let us now look at the effect of the "shock" measures—fiscal, monetary, price—on *production* and then on investment. During the period 1989-92 all these countries shared the experience of substantial falls in production and GNP. This has some evident negative effects: real incomes of the population decline, shortages are exacerbated, and/or the price increase required to bring supply and demand into balance is even higher than had previously been necessary, while budget revenues are affected because of a reduced tax base. Why has there been so severe a fall in production? In Poland, for example, industrial output fell by 24 percent in 1990 and by another 20 percent in 1991. It is true that these figures may somewhat overstate the decline, because some private activities that have grown have gone unrecorded. None the less, one can speak almost of a *zakonomernost'* (regularity), echoing Bukharin's "negative expanded reproduction," to cite *his Economics of the Transition Period.*

It has been severe indeed. According to the ECE Economic Survey of Europe, 1991-1992, the picture was as follows (percent):

	Industrial Output		Gross Fixed Investment	
	1990	1991	1990	1991
Bulgaria	-14.1	-27.3	-12.0	-49.3
Czechoslovakia	-03.7	-23.1	+07.7	-36.0
Hungary	-05.0	-19.1	-08.7	-11.0
Poland	-23.3	-11.9	-10.1	-08.0
Romania	-19.8	-18.7	-35.0	-16.8

In Russia the decline accelerated in 1991 and especially in 1992, when total investments fell by nearly 50 percent.

The steep decline in living standards are reflected in the fall in the volume of retail sales, which (according to the same source) fell in the single year 1991 by 52.8 percent in Bulgaria, 39.4 percent in Czechoslovakia, 28.2 percent in Hungary and 27.3 percent in Romania. In every country the fall in output exceeded the most pessimistic expectations of the reformers and of their foreign advisers. As the ECE survey put it, "the market transformation was expected not only to eliminate the inefficient activities, but also to stimulate the expansion of the more efficient, so that a dramatic fall in overall production was not seen as a real possibility" (p. 46).

Let us now look at causes and consider whether this outcome was avoidable.

One factor, which also figured in Bukharin's book, was the short-term disorganizing effect of the transition itself. People at all levels were accustomed to operate within the old system via a multitude of informal links that supplemented or sometimes replaced the formal structures. The old links are weakened or abolished, but the new ones cannot instantly replace them. This affects material supplies, managerial behavior, the workers, and the law enforcement agencies. There is a lack of market culture, infrastructure, training, and information flows. In agriculture, it must take time to replace state and collective farms. Meanwhile, there is uncertainty and confusion that immediately brings about negative effects on production.

All this was exacerbated by political and territorial disintegration. The collapse of Comecon was accompanied by a drastic cutback in "East-East" trade, harming all through the disruption of supplies and the disappearance of established customers. Thus, the output decline in Poland, Hungary, and Bulgaria was in part due to the collapse of trade with the Soviet Union, and the former Soviet republics have suffered from the non-arrival of machines and components from their former Comecon partners. The same negative effect has followed from the disintegration of the Soviet Union, with each of the republics obstructing the free movement of goods and materials to other republics. This is occurring also within the Russian Federation. Thus, Tatarstan (formerly the Tatar Autonomous Republic) seeks its own sovereign right to export its oil and to keep the hard currency so earned. Oil output in Russia (including Tatarstan), in any event, is declining, and the fall in export receipts has a negative effect on capacity to pay for imports.

Then there is the effect on demand of the deflationary policies, intended to achieve macroeconomic stabilization. The freeing of prices has been accompanied by a much smaller rise in average incomes. This has cut back real purchasing power, and the impoverished have switched their purchases towards the cheaper foods, leaving less to spend, for example, on sausage, clothing, consumer durables, and luxuries. So, in varying degrees the decline in production can be explained both by supply bottlenecks and demand deflation. In Poland it is the latter that is largely to blame, but pressure to increase personal incomes has been resisted because of its likely effect on speeding up inflation. In Russia supply disruption seems to have been more serious, though in 1992 demand also fell steeply.

A further cause of decline, and of rising unemployment, has been the attempt to weed out inefficient and subsidized enterprises, as well as those which may be producing (even "efficiently") goods not in demand. This process has been proceeding slowly in most countries, for fear of the social and political consequences of mass closures, but it is set to accelerate. In all these countries a large proportion of industrial enterprises are in fact insolvent. In Poland, Czechoslovakia, and Hungary, the move towards currency convertibility and import liberalization has brought about a sharp rise in imports of consumer goods of many kinds, which tend to displace the locally made products, further negatively effecting output. Thus, in Poland the decline was particularly severe in "light industry," that is, in manufactured consumer goods, since Western goods are preferred.

Was a decline in GNP inevitable? Probably the answer is "yes," but surely the scale of the decline, especially in Poland and Russia, has exceeded the expectations of the reformers and represents a cause for alarm.

INVESTMENT

This brings us to the vexed question of investment. It is evident that restructuring, industrial modernization, conversion of the military sector, and the building up of a sadly neglected infrastructure call for the investment of large capital sums. So does repair of ecological damage, which has been severe in all these countries. All critics agree that the structure of the economy inherited from the Soviet-dominated past is irrational, that part of it is uneconomic and will have to close, and that one result must be a rise in unemployment. So it is essential to provide not only retraining but also new workplaces. Who is to do this? Where is the capital to come from?

It is a common feature of all ex-Communist countries that for evident reasons legitimate capital accumulation in private hands is far too small and most of the rich are suspected of having acquired their riches by corrupt means. This complicates the task of privatization, of which more will be said below. It also severely limits the *private* financing of investment. The Hungarian economist Laszlo Csaba speaks of the need to create "an environment where putting money into a (long-term) investment—rather than consuming it or putting it in a foreign bank—makes economic sense, or at least is one of the options. 'Private' entrepreneurs of the irregular or 'Mafia' economy of the post-socialist countries normally do not risk their own money. Productive investment is the last thing they would think of."[6] Clearly, even in Hungary, more advanced in such respects than Russia, Romania, or Ukraine, a modern capitalist class has yet to be created, and it is wrong to assume that it already exists and will react "rationally" to investment opportunities. In any case, in many countries the degree of uncertainty about politics, policies, rates of inflation, possible public disorder, exchange rates, plus high interest rates, are such as to deter entrepreneurial investment, diverting resources into short-term dealing. This has been particularly evident in Russia, where (in May 1992) the bank rate had been raised to 80 percent, which is admittedly below the expected rate of inflation, but sufficient to deter borrowing for the long term.

Investment statistics can be misleading, and not only in the "East." There has been a profusion of new financial institutions—commodity exchanges, brokerage houses, commercial banks—which are laying the foundation of a capital market. But so far they invest little; there is too much money to be made out of dealing and arbitrage.

If private sources of investment are highly limited—and, as we shall see, still further limited by diversion into privatization buyouts—two sources

6 *Acta oeconomica*, vol. 43, 3-4 (1991), p. 283.

remain: public authorities and foreigners. If neither are forthcoming, or remain very small, then output will begin to fall because of net *dis*investment, that is, net investment will become negative, gross investment will fall below the level of physical depreciation, obsolete equipment and antiquated industries will remain obsolete and antiquated, and plans to create competitive industrial structures will stay on the drawing board. Foreign inward investment can make a significant contribution, but its scale in most countries will surely remain small, and especially so in Russia and other countries in acute economic crisis.

This suggests the need for what could be called selective interventionism, an industrial *policy*, an investment *strategy*. There are plenty of examples from which to learn, as already argued earlier: postwar Europe, South Korea, Japan, and, quite strikingly, the former East Germany, where investment expenditure has been massive.

There is an important gap in neo-classical economic theory based upon general equilibrium. Long-term real investment occurs under conditions of actual or anticipated *dis*equilibrium, for example, where there is actual or anticipated market domination (temporary monopoly), collusion, and/or government-sponsored coordination and protection. The idea that the breakup of large firms in the name of anti-monopoly measures, the maximization of domestic and foreign competition (and so of uncertainty as to future profits) is conducive to investment should surely be seen as a naive fallacy, even in long-established capitalist countries. *A fortiori* (or so one would have thought) laissez-faire cannot be the remedy in countries suffering from structural deformations inherited from the past and with little private capital.

"INTERVENTIONISM"

"Oh, yes, it can," is, however, the answer given by most of those in charge of the transition process. For a clearly-presented view, one can refer to the article by Marek Dabrowski on "interventionist pressures."[7] Dabrowski writes from personal experience as the former deputy minister of finance in Poland. He was critical of "the demand for a kind of government industrial policy," against any budgetary sums being allocated for restructuring, or "state influence on the branch structure of the economy," involving "priority in government policy" for specific branches or sectors. All he would accept would be what he calls "active anti-interventionist interventionism." He sees dangers of "continuing the planning mentality," the emergence of bargaining with interest groups, undermining "the possibility of enforcing a hard budget constraint on firms," threatening a balanced state budget, and so on. He is firmly against using "interventionist tools as a substitute for the market mechanism." Such sentiments echo those of V. Klaus in Prague, K. Kagalovsky in Moscow, and some (but not all) the reformers in Budapest. Klaus reportedly disapproves of the interventionist and evidently strategic activities of *Treuhand*, the institution set up to modernize, restructure, and privatize East German industry and infrastructure, since this seems to resemble some kind of "socialist" planning. In the case of Poland, Dabrowski's negative attitude is strongly supported by Wienecki.[8] The very *scale* of West German commitment of resources to East Germany reminds one, first, of the magnitude of the gap between the two halves of Germany, from which some moral can be drawn about the relative efficiency of systems. Second, it is useful to contrast the sums involved—150 billion DM in just one year—1991—a total sum that is likely to exceed 200 billion dollars. This for a population of 16 million. Compare the likely injection of aid and credits into the rest of the eastern half of Europe, for example the 24 billion for all of the ex-Soviet republics. Third, it is worth studying in detail how these very large sums are targeted. As in South Korea, this is most emphatically not laissez-faire.

However, it is also worth citing another of Dabrowski's objections to "interventionism": the lack of what he calls "a good civil service." The same point was made by several of my Russian colleagues: an interventionist policy needs efficient and reliable state officials, "interventors," as well as power to implement policy. It may simply be impracticable to "intervene" effectively without them. This is a very different reason for non-intervention, a reason purely practical, not ideological. It seems to me that in the situation that Russia finds itself, if steps are not taken to impose priorities and direct some investment into key areas—agriculture, en-

7 *Communist Economies*, no. 1 (1992), pp. 59-74.
8 *The Structural Legacy of Soviet-type Economy* (London: RCE, 1992).

ergy, infrastructure, for instance—decline must continue, since private capital cannot be expected to fill the gap left by the withdrawal of the state from responsibility in the absence of any investment strategy. Chaos and anarchy are already near.

One cannot sufficiently emphasize the investment problem. How can the restructuring of these economies, the modernization of their industries and of their infrastructure, the urgently necessary cleanup of the environment be undertaken without a major role for public authorities? How, in the situation they are in, can one expect the private sector and laissez-faire, guided by the profit motive, to do the necessary? Meanwhile, to repeat, net investment is negative in several of these countries, and privatization has mainly "benefited" trade and distribution, not production. Prospects are more promising where the inflow of foreign investment can be expected to fill the gap.

PRIVATIZATION

This brings us to the important question of privatization. This divides into several parts. First, *what* to privatize, that is, what, if anything, ought to be left in the public sector in the longer run. Second, *how* to privatize, *who* should own. Third, the question of *speed:* how fast to proceed and in what order. All this under conditions of shortage of savings and of privately-owned capital. Claims to restitution of property confiscated by the Communists further complicates this issue in some countries. This is a problem not only in such countries as Poland, Czechoslovakia, and Hungary, but also in the Baltic republics of the former Soviet Union. This delays privatization, since many purchasers fear the appearance of a claimant who may by now be living in Florida or France. For example, the son of the former owner of a farm in Hungary may now be a computer operator in Chicago; in addition, there are survivors of great landlords, expropriated in postwar land reforms. It is important to dispose of this problem as quickly as possible, perhaps best by granting the right to monetary compensation up to a certain limit.

The answer to the question of *how* and *who* is very difficult and there have been numerous schemes. Two incompatible aims further confuse the issue: on the one hand, the widest possible degree of stock-and-share ownership, and on the other, the encouragement of the owner-entrepreneur. All such schemes as the issuance of vouchers, either free or at a low cost, which aim to ensure the direct interest of the citizens in ownership, have two defects: (1) ownership becomes diffused and anonymous; (2) if the stocks are underpriced and saleable, many will be sold, thereby providing additional income to the seller and thereby adding to inflationary pressure. Ignorance of the (still primitive) capital market could well cause owners of vouchers to entrust them to various kinds of capital funds and investment trusts, which may or may not exercise some control over management.

Then there is the so-called "spontaneous" privatization that merges with what is called "nomenklatura" privatization, of which there are many variations. They have in common the appropriation of capital assets of state enterprises by existing management, with or without the participation of former Party and state officials turned neo-capitalist, and sometimes in conjunction with some degree of employee shareholding. Firms can be acquired by purchase of undervalued assets at low prices, or by the creation of pseudo-cooperatives, or with the help of merchant banks. In several countries this process has been associated with corruption, insider dealing, and other forms of fraud. Some denounce this as outrageous. Others look more tolerantly at "primitive capitalism red in tooth and claw," and hope or expect that these new owners will learn to behave like capitalist entrepreneurs, since at least they have shown enterprise in acquiring property. It is hard to prove that assets are undervalued, since their future earning power is in any case unknown.

It may be that large accumulations of wealth achieved by dealers, inside and outside of the new commodity exchanges, will one day be invested in productive activities, that meanwhile this is a (very) primitive form of primitive capital accumulation.

There is also the transformation of state enterprises into joint stock companies, where at least initially the majority of shares is held by the state, directly or through a fund for administration of state property. Management is instructed to act "commercially," with profit as the efficiency criterion. Shares can then be gradually sold off. To close them all down would lead to disastrous cuts in output and a rapid rise in unemployment. To sell off only the profitable ones would leave the state with the burden of supporting the loss-makers.

A useful intermediate stage is *leasing* properties to managers. The lease could be nominal for the less profitable, larger (a fixed sum, or a share in profits) for the more potentially remunerative. It postpones the vexed question of valuation of assets, which

depends on information and prospects that are hidden at the beginning of the privatization process. Leaseholders who fail could be replaced by others at the discretion of the property agency.

Sales of firms by *auction* have also been attempted. The usual criticism is that if foreigners are excluded, purchasers will in the main be shady dealers, "Mafia" and/or corrupted officials of the old regime. And, of course, foreigners could act by using overvalued hard currency via corrupted local intermediaries or disguised "joint ventures."

Giving shares away, whether to the population at large or to the workforce, has the evident defect that some enterprises are much more valuable than others, so the gains would be very unfairly distributed. But fairness is, in any event, unlikely.

THE LATIN-AMERICANIZATION OF EAST EUROPE AND THE FORMER USSR

Foreign investment is surely to be encouraged, insofar as it creates new productive capacity or modernizes the equipment (and managerial practice and technical know-how) of existing enterprises. But there is understandable fear that at highly unfavorable exchange rates (unfavorable for the domestic currency and citizenry) foreigners will buy up firms and property on the cheap, requiring that limits be set on such acquisitions. Joint ventures have long been encouraged. In such countries as Russia, uncertainty about policy and confusion as to who is authorized to authorize inhibits progress: there is still (June 1992) no clear legal order, and national republics and regions claim property rights over natural resources. Some successor republics have done better: Kazakhstan, for example, has signed a major deal with Chevron Oil Company. There is a fear, voiced for example by T. Cox,[9] of what some call the "Latin-Americanization of Eastern Europe," that is, the creation of foreign-controlled enclaves, "and a less developed national sector starved of investments remaining under the control of the national elite."

One reason for underinvestment, not yet mentioned, is the diversion of capital and savings into acquiring what already exists. This has also been a feature of British privatization. This would not matter if the receipts from sales of public assets were used for investment purposes, but this (in Britain) has been barred by ideology; they have in fact been used as state budget revenue and/or to reduce public debt. Little thought seems to have been given to the sources of investment financing. In the United States under Reagan and (especially) Bush, the major part of domestic savings has been used to finance record budget deficits, and many American commentators identify this as a cause of America's relative decline as compared with Japan. So the problem is not confined to the eastern half of Europe.

Finally, another form of privatization, or more precisely, de-etatization, must be mentioned: sale to the workforce, or the transformation of the firm into cooperative property of some kind. Here, somewhat surprisingly, some of the ideologists of the "East" are *plus royaliste que le roi*. Thus, even the Conservative government in Great Britain accepted the employee purchase of a major road transport undertaking and coal mines by groups of miners. Yet, in his book,[10] Kornai opposes these kinds of co-ownership, and in Russia the minister in charge of privatization, Anatoly Chubais, has drafted a law that limits the employees to acquiring, on favorable terms, 25 percent of the shares, *non-voting*. There is an ideologically-based negative view of worker control or ownership. The weakness of political parties representing the workers lessens the pressure for this solution.

The ideologists cite the example of Yugoslav self-management and similar experiences. Yet Yugoslav enterprises were *not* owned by their workforce, and so the latter had no interest in the value of capital assets or in the long term, and naturally pressed for higher incomes. The models that analyze the behavior of employee-managed enterprises do so on artificial assumptions. Thus, the well-known "Illyrian" model of Benjamin Ward assumes perfect competition and abstracts therefore from real competition, and, as do all the models, from the possible effect on performance (and on the willingness to accept technical change) of a sense of co-*ownership*. Any factor that is ignored in any model has a weight of zero. This particular one can be decisive one way or the other. One should study the more positive experiences of Mondragon

9 "Privatization and New Economic Groupings in Hungary" (Conference Paper, Glasgow, 1992).
10 *The Socialist System* (Oxford University Press, 1992).

in Spain, and of the many millions in the United States who work for the employee-owned firms ("ESOP," Employee Stock Ownership Program). It is odd to read articles in the Russian press written by American scholars[11] extolling employee ownership and criticizing the now-fashionable negative approach. This is also my own position. It seems remarkably "ideological" to *assume,* for instance, that the Avis car rental firm (employee-owned) must be less efficient than Hertz (not employee-owned), or that the former is less likely to invest in its own future than the latter. Yet Kornai obstinately defends the view that co-ownership only works if confined to religious or political enthusiasts (for example, the Israeli kibbutz). And, if it is objected that Russian or Polish employees are not steeped in market culture, the same applies to the would-be neo-capitalist owners too.

No doubt there is much scope for private, non-state enterprise, for speedy small-scale privatization, especially in the service sectors (trade, repairs, building and decorating, goods transport, and so on) and workshops of many kinds, despite the difficulties of valuing capital assets amid major uncertainties and inflationary pressures. It must not be forgotten that the value of any capital asset depends not on its initial cost, but on anticipated future income streams, on its expected profitability. Getting it wrong for shops or workshops matters little. It is more complicated for the larger firms, which is an argument, along with the lack of domestic capital, for proceeding slowly.

It is worth referring at this point to efficiency criteria for those industries and firms that remain in the public sector. If a major reason for remaining in the public sector is their "externality-proneness" (for example, transport, docks, posts) or because they are natural monopolies, there are dangers if they are told to act "commercially": that is, to maximize their own profits regardless of external effects. I wrote on this theme twenty years ago, referring to British experience.[12] Externalities should not be ignored in externally-prone sectors.

DE-COLLECTIVIZATION

Agriculture presents problems of its own. Here Poland is exceptional in that the bulk of its peasants were not collectivized. In other countries (except former Yugoslavia) the issue of de-collectivization/privatization is on the agenda. Meanwhile, existing state and collective farms are in a very difficult position, since their management has no notion of what the future holds and investments have fallen steeply. Apart from the issue already mentioned of returning land to former owners, there is the question of peasant attitudes: how many would wish to become private farmers, if they were adequately remunerated for collective work with (for them) minimum risk and responsibility? Particularly when credit is scarce and interest rates high, there is a shortage of suitable equipment and building materials, and great uncertainty about prices of inputs and farm products. In some countries, notably Poland and Hungary, the potential market for farm products in Western Europe is barred by the Common agricultural policy, which is likely to remain for many years yet, given political realities in the West.

The most difficult path towards privatization is surely to be encountered in Russia and Ukraine. The Chinese experience is of little relevance, since Chinese "collective" cultivation had been on small fields by medieval methods, and decollectivization required little change in method or technique, while providing better incentives, so that the result was positive and quickly so. Large fields and mechanized harvesting on the Russian and Ukrainian prairies are a very different proposition. And many sources attest to "depeasantization." The short-term danger is that the disruption of *sovkhozy* and *kolkhozy* will not be compensated by the larger output of the new private farms, and that shortages of food could get worse before they get better.

In Poland the smallholders are very small, suffer from diseconomies of *small* scale, as well as a price policy that leaves them to swim in the cold water of the free market. Prices of basic farm products are regulated in some way in just about every country of the world. The neo-liberals ascribe this to the influence of the farm lobby, and this may well explain the *level* of subsidy or protection. But surely there is another reason. Agriculture approaches the "ideal" of perfect competition; there are very many small producers who cannot directly influence price. This, plus the "cobweb" effect arising from the seasonal nature of farm production, could cre-

11 For instance, J. Simmons and J. Lout in *Izvestiya,* April 1, 1992, and in *Voprosy ekonomiki,* no. 2 (1992).
12 *Efficiency Criteria for Nationalized Industries* (London: Allen & Unwin, 1973).

ate an intolerable degree of price fluctuation, which argues for some kind of price stabilization scheme. At the very time when private farming is on the agenda, it is being discouraged by adverse (and uncertain) price movements. Thus, in Russia in 1991-92 prices of farm inputs have risen twice as fast as prices of farm products.[13] Again—is laissez-faire the answer?

SOCIAL PROBLEMS

Next let us consider the social problems: employment, health, education, housing. Some rise in unemployment is inevitable, linked with the closing of chronic loss-makers and a shake-out in overmanned enterprises. But, just as the decline in output is in danger of exceeding reasonable bounds, so is the rise in the number of jobless. Especially if it coincides with cuts in the level of provision of public services. It has been the common experience of Eastern Europe that it has not (so far) been found possible to close down the majority of loss-makers, otherwise the rise in unemployment would have been much higher.

While some have found work in privatized services or undertake typically third-world informal-sector activities, such as selling in the street (as can be seen in Polish and Russian cities), unemployment becomes a major social problem. Apart from the threat to public order, it is also wasteful, surely an evil to be minimized. The notion that labor markets clear if wages are not downward sticky is highly questionable, even in normal times. However, at free exchange rates the average wage in Russia in May 1992 was at most $15 per month, below modest subsistence levels in terms of the ruble prices ruling at this time. Job creation calls for investment, but as already pointed out, investment has fallen steeply. In Russia matters are further complicated by the reduction in military personnel and the arrival of refugees from some of the other ex-Soviet republics. There are plenty of essential public works that require attention, given the state of roads and other infrastructure, yet financial stringency leads the government to cut such expenditures. This way lies social explosion.

Meanwhile, health services are also cut, while the idea of semi-private insurance is mooted as an alternative. In most of these countries state enterprises provided some of the social services—nurseries, holiday homes, dispensaries—and these, too, are abandoned or put on a cost-covering or profit-making basis as part of the process of commercialization. The press reports a sharp rise in infant mortality[14] and a net fall in population. (If laissez-faire leads to surplus deaths, should this not be a matter of concern?) Spending on education, scientific research, and culture is being severely reduced, particularly in Russia. Private provision is moving into the vacuum for those who can pay. The average citizen has already suffered a decline in real income. (Its full extent may be overstated if one simply compares incomes and prices, since there is now a wider choice, more goods in the shops, but no one denies that real incomes have fallen.) A new class of rich dealers and small entrepreneurs, and also those who have devised joint ventures which yield hard currency, are now visibly rich. The large increase in differentials suggests the need for an appropriate tax policy. However, even such non-extremist economists as Janos Kornai are so committed to encouraging entrepreneurship and combatting what they regard as the excessive egalitarianism of the past that they advocate *lowering* taxes on high income.[15]

INCOME POLICY

The question of an income policy is also highly controversial. During the period 1990-92 in Poland there was rigid control over wages in the state sector (that is, for the large majority of workers and employees), keeping increases far below the rate of inflation. This attracted criticism from both Milton Friedman and from the trade unionists: it is an odd kind of ideology that advocates the freeing of all prices *except* the price of labor. It is also socially divisive: those whose incomes are identifiable and controllable, whether blue or white collar, are impoverished, while those who are not wage-and-salary employees earn whatever they can, and so benefit from redistribution in their favor. In some countries wages in the state sector remain rigidly controlled, while incomes of private entrepreneurs and of anyone employed in the growing private sector are left free. This is another recipe for social

13 G. Yavlinsky, et al., *Moskovskiye novosti*, May 24, 1992.
14 Yeltsin deplores this in *Rossiyskaya gazeta*, June 2, 1992.
15 Janos Kornai, *The Road to a Free Economy* (New York: Norton, 1990).

conflict, though the gravity of such conflict depends on the degree of economic decline and impoverishment. Thus, Hungary and the Czech lands are under much less social strain than Russia. Where catastrophe threatens, it was usually found politically desirable at least to claim a degree of equality of sacrifice. In wartime Britain the King had a ration card. It would have made no difference to Britain's food supply if he had not, but symbolically it was important. One has the feeling that such economists as Jeffrey Sachs would not find such an argument had meaning.

Perhaps the *pessimum pessimorum* is what actually has happened in Russia in 1991-92: in some key sectors, for example, the coal mines, the workers have secured literally tenfold wage increases, leaving far behind fellow workers outside of the coal industry, not to mention doctors and teachers, whose pay in May 1992 was literally one tenth of that of the miners. This is neither a coherent incomes policy nor a real labor market.

FOREIGN TRADE AND CURRENCY CONVERTIBILITY

Lastly, let us turn to the linked issues of foreign trade and currency convertibility. Here, too, the more naive forms of laissez-faire and free-trade ideology seem to have acquired a grip on the reformers' minds. Again, one must distinguish the short-term problems from longer-term desiderata. All these countries look forward to being included fully in the international division of labor, or more specifically, in the European Economic Community. Naturally they wish their currencies to become convertible. These are aims that I for one do not wish to question. However, this was also the aim of West European countries in the early postwar years, but under conditions of chronic dollar shortage on the one hand, and the urgency of reconstruction on the other, there were restrictions on both trade and currency, and exchange rates were "managed." France and Italy retained some limits on currency convertibility until 1990.

Do or should similar considerations apply to Russia, Ukraine, Poland and the rest? Let us examine the reasons behind the restrictions mentioned above.

One was connected with the *priorities* of reconstruction. These varied in different countries, but in general there were limits set on the use of (scarce) dollars for the purchase of what were judged to be inessentials. For example, in 1948 one saw very few American cars on Europe's roads. They were prevented either by import licensing (currency rationing) or by high import duties. The effect of premature import liberalization would have been a steep decline in the exchange rates of the national currencies, since pent-up demand for imports (as for investment) was so great after wartime austerity and destruction. How different is the approach of the men now in charge in the "East." Here, for example, is the influential Russian economist, Konstantin Kagalovsky:[16] "The rate for the ruble will be the same for all, and licenses and quotas will be liquidated. All foreign loans will be realized in the market at the market rate... Any administrative ways of supporting critically essential imports are shown to have been totally pointless." Why? Because when asked one ministry wished to give priority for materials to brew beer!

In Russia, at least, this does seem a recipe for speedy disaster. For reasons already discussed above, investment has collapsed, as have medical services, and there are acute problems with food and transport. In the short run the liberalization of trade plus currency convertibility would have predictable effects: those who have accumulated millions of rubles (firms or individuals) will salt them away in banks abroad (which many have already done, despite the rules forbidding this), while others will buy consumer goods (panty hose, cars, etc.) for instant resale. Foreign loans will be speedily used up with minimum effect on the much-needed reconstruction or on the needs of the impoverished majority.

There is also the effect of import liberalization on domestic production and investment. One recalls Nicholas Kaldor's case, which is a gloss on the long-familiar "infant industry" argument for protection. Industry is characterized by increasing returns. Referring to the effect of free trade on Great Britain in this century, he wrote: "Our adherence to free trade meant that a lot of *new* industries... could not be properly established here. As the traditional industries became increasingly unprofitable, our savings were increasingly invested abroad." His-

16 *Izvestiya*, May 6, 1992.

torically, as he pointed out, "Germany, France, the United States, Japan [and South Korea, too] began to foster their manufacturing industries behind the shelter of protective tariffs."[17] How, then, is restructuring to be achieved in the ex-Communist countries? Will not import competition be destructive in the short term, unless some choices are made as to what sectors should be protected or encouraged? (In fact, some foreign investors have been requesting protection.) To men like Kagalovsky or Sachs such thoughts must seem heretical. They must hope that foreign investors could hope to utilize the well-educated and low-paid labor force and put their money into industries which can speedily become competitive. Perhaps they imagine Hong Kong can be reproduced. But can it?

So—to recapitulate. We must beware of generalizations, there are big differences between countries, in political and market cultures, in levels of development, in the degree of inherited imbalance, and so in the response to be expected from shock therapy and laissez-faire policies and potential foreign investors. Russia is in a situation very different from that of the Czech republic, especially without Slovakia. But in these countries the transition to a market economy is accompanied by a steep decline in output, in living standards, and in the provision of social services. In all of them the decline in state-financed investments is not and cannot be replaced by private-sector investment. Yet there is a reluctance even to consider an investment *strategy* or industrial *policy*, as if a real capital market already exists. The problem of transition cannot be tackled or understood within the neo-classical paradigm. Though it is certainly true that elementary economic propositions are both valid and important—supply and demand, opportunity cost, the consequences of price control and of printing too much money—these propositions were not only familiar to the readers of Marshall one hundred years ago, but can be traced back much further. The essentially incremental, non-institutional, timeless, equilibrium-oriented neo-classical mainstream, with its methodological individualism, is largely irrelevant. To cite Dietz once again: "The reality of reform in Eastern Europe and in the (former) USSR displays a dynamic that leaves mainstream economics more or less speechless." And Frank Hahn, himself a neo-classicist of distinction, has written apropos of some mainstream models: "When policy conclusions are drawn from such models, it is time to reach for one's gun."[18] Yes, indeed. It is perhaps understandable that from the extreme of total state monopoly and state-party domination that the pendulum swings far in the opposite direction. Yet in several countries, Russia in particular, it is hard to see how one can rely on a market mechanism that has yet to be created, while decline accelerates and a new Time of Troubles looms ahead. To create the preconditions for a market economy surely requires action, "interventionism," under conditions of dire emergency analogous to a wartime economy, with the real supply side in such disarray as to render impossible macroeconomic stabilization.

IDEOLOGY AND ECONOMICS

Meanwhile, it is also appropriate to ask: What is the social basis of the policies followed by Vaclav Klaus, Yegor Gaidar, Leszek Balcerowicz and their many associates? In a perceptive article, Deborah Duff Milenkovitch, writing about the old system, remarked that "ideology as an abstractly given set of goals provides an unconvincing explanation for the organization and strategy choices of socialist societies." She points to ideology evolving so as to "constitute a rationale for the policies preferred by the governing elite, policies which focused on their maintaining monopoly control of all important economic and political organizations." Yes, as she says, "ideology is never independent of the interests of the ruling elite." Who *are* the "ruling elite" today? Clearly, the interests of the ordinary worker seem to be disregarded. Peasants are unhappy too, even (or particularly) in Poland, as they are hit by the deflation of their customers' incomes, high interest rates, and abolition of subsidies. The new would-be capitalists are not (not yet) in a position to influence basic policies. The old nomenklatura is in disarray. Into this vacuum has come—who? A segment of the intelligentsia, converted from the Marxism which most of them espoused at an earlier stage of their careers into a new religion—Chicago economics. Twenty years ago two Hungarians, Konrad and Szelenyi, speculated about "the intellectuals on the road to class power," this being their view of the intellecutals' role in the old Communist-dominated

17 *Further Essays in Applied Economics* (London, 1978), p. 239.
18 "Reflections on the Invisible Hand," *Lloyds Bank Review*, no. 144 (1982).

regime. I disagreed with them. But today such a view may be closer to the truth. The new Bukharins, young and committed as was the Bukharin of 1920, are convinced, as he was, of the correctness of their vision, their right to lead the people into the Promised Land. But are they on the right road—even accepting their choice of destination?

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